[JOINT COMMITTEE PRINT]

BACKGROUND
ON
COMMODITY TAX STRADDLES
AND
EXPLANATION OF H.R. 1293

SCHEDULED FOR A HEARING

BY THE

COMMITTEE ON WAYS AND MEANS

ON APRIL 30, 1981

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INTRODUCTION

This pamphlet provides background information for a public hearing scheduled on Thursday, April 30, 1981, by the House Ways and Means Committee on H.R. 1293 (and H.R. 1338, an identical bill) and other legislative proposals relating to tax straddles. Because most tax straddles are structured at least partially in commodity futures contracts, the pamphlet describes the futures industry, futures trading, and tax-motivated transactions in futures. In addition, the pamphlet outlines the present law governing the taxation of futures transactions and explains the provisions of H.R. 1293 (and H.R. 1338).

I. PREFACE

Interest in the use of commodity futures transactions for tax-motivated purposes has grown rapidly in recent years. The Internal Revenue Service has disallowed certain deductions relating to such transactions and taxpayers have challenged the IRS position. The lead cases [1] involving tax straddles in commodity futures, the most publicized of these transactions, are being litigated currently in the United States Tax Court.

Varied legislative changes have been suggested in the tax treatment of futures transactions and have been discussed informally by legislators, government officials and industry representatives. Identical bills, H.R. 1293 and H.R. 1338, have been introduced in this Session of Congress. These bills include provisions intended to limit the use of a variety of transactions, including tax straddles in commodity futures and other property, to shelter income from taxation.

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[1] *Smith v. Commissioner*, Docket No. 12709–77, and *Jacobson v. Commissioner*, Docket No. 185–78.

II. BACKGROUND ON THE COMMODITY FUTURES INDUSTRY

A. Development of the Commodities Industry

Present day commodity futures exchanges can trace their origins to medieval European markets usually held at the principal regional center of production for a particular commodity. Initially, only physical ("cash") commodities were traded. However, as commerce grew in size and complexity, markets expanded to year-round operations and trade in contracts for future delivery developed. Trading practices became standardized and over the centuries, some trade practices were adopted as law.

In the United States, regional cash markets for agricultural commodities developed in the Eighteenth Century. Trade in cash commodities was marked by wide seasonal variations in supply and demand resulting in large fluctuations in prices. At harvest time, farmers glutted the markets with their produce, which far exceeded merchants' immediate needs. Inadequate transportation and storage facilities compounded farmers' economic difficulties. Prices were low; some commodities were kept off the markets; others spoiled and remained unsold. Within months, however, demand would increase and prices would soar as the supply of produce sought by merchants, processors and individuals dwindled and fell short of demand.

In order to increase their control over supply and demand, producers and users of agricultural commodities began to enter forward contracts with each other. Forward contracts are individualized agreements directly negotiated between a particular buyer and a particular seller, and always requiring actual delivery. These contracts called for delivery of a fixed quantity of a commodity at a specific place at a particular time for a fixed price. Forward contracts provided that actual delivery of the commodity would occur in the future, but title to the commodity was transferred when the parties executed the contract.

Although some individual speculation in forward contracts occurred, such speculation was too irregular and insufficient to reduce the risk of price fluctuations. Forward contracts permitted a shifting of the risk of future price fluctuations from the seller to the buyer, but because they required actual delivery of the commodity, they were not very attractive to speculators who might otherwise have been willing to assume the risks of price changes. Futures contracts and futures exchange developed as a means of encouraging speculators to enter the commodities markets and assume the risk of price fluctuations. Knowledgeable, well-capitalized price speculators typically make markets more efficient because their trading responds quickly to information about changes in supply and demand. Also, the active trading of speculators usually makes markets more liquid; that is, it reduces the gap

between the prices at which the public is able to buy and sell the commodity.

In this century, futures trading has become increasingly regulated, both by the industry itself and by the Federal Government. Initially futures trading in agricultural commodities was regulated by the Agriculture Department under the Commodity Exchange Act. Later additional commodities were made subject to regulation. The Commodity Futures Trading Commission Act of 1974 created an independent federal agency, the Commodity Futures Trading Commission, and granted it exclusive jurisdiction over futures trading.

B. Commodity Futures Contracts

A commodity futures contract is a standardized agreement either to buy or to sell a fixed quantity of a commodity to be delivered at a particular location in a specified month in the future. Currently, exchanges list contracts for agricultural commodities, heating oil, precious metals, financial paper and currencies. Called "futures," these contracts require payment at the time of delivery.

In the United States, all trading in futures must be transacted through an exchange by exchange members. Futures traders are not allowed to sell futures contracts which they have executed to third-parties off the exchange.

A clearing association at each exchange guarantees performance on commodity futures contracts, i.e., the clearing association interposes itself as a buyer to every seller and seller to every buyer. The association is substituted as the opposite party in every trade and becomes the payment and collection agency for its members. Thus, responsibility on a contract runs between the clearinghouse and the clearing member, for example, the brokerage firm, which executed the contract for its customer.

All futures contracts are subject to the rules and regulations of the exchange where they are traded. For each contract, an exchange establishes a standard contract size. For example, a soybean futures contract consists of 5,000 bushels. Each contract specifies delivery of a particular grade of the contract commodity. Exchange rules may allow a seller to substitute delivery of the standard grade with other specified grades of the commodity, at stated premiums or discounts from the delivery price.

Exchanges list contracts for delivery only in certain designated months, some almost two years into the future. The Chicago Board of Trade, for example, presently lists wheat contracts for May, July, September and December 1981 and March and May 1982. The New York Commodity Exchange (COMEX) lists gold contracts for delivery in April, May, June, August, October and December of 1981, the same months plus February for 1982 and February 1983. Closing futures prices are listed daily in the financial pages of many newspapers.

C. Futures Trading

1. Types of traders

Hedging

Commodities futures trading involves two types of trade: hedging and speculation. A hedger is a business person who produces, sells, or processes the actual "cash" commodity and engages in futures trading for price protection of inventories. For example, a wheat farmer who expects to harvest a crop several months in the future may enter a futures contract to sell wheat to protect against a price decline between the current date and the date when the actual wheat will be available. Also, a flour manufacturer may enter a futures contract to buy wheat to protect against a price increase between the current date and the time when the manufacturer will need the actual wheat.

Speculation

A speculator does not trade futures for price protection, as the hedger does. Instead, the speculator risks his capital in the hope of profiting from price movements.

Speculators buy if they think prices are too low; they sell, if they consider prices too high. Speculators generally do not take delivery of the physical commodity but instead "liquidate" (i.e., close out or cancel) their futures by making offsetting purchases or sales of an equivalent quantity of futures contracts in the same commodity for the same delivery month. Speculators generally hold their contracts for short periods; some are day-traders, often called scalpers, who get out of the market the same day they get in.

A speculator cannot simultaneously hold an equal number of contracts to buy and to sell the same commodity for the same delivery month on a single exchange. Under exchange rules, such contracts cancel each other out. A speculator who wishes to get out of ("liquidate") a purchase contract prior to the contract's delivery month can "cancel" the contract, and terminate any obligation under it, by executing an equivalent sales contract for the same month on the same exchange.

Obviously, any one person may trade futures contracts, sometimes as a hedger and other times as a speculator, depending on the purpose and the type of transactions which are executed.

2. Trading strategy

Futures v. cash prices

Speculators employ a variety of trading strategies. Traders expecting prices to increase may take a "long" position, that is, enter into contracts to buy a commodity. If a trader expects prices to fall, he may go "short," that is, enter into contracts to sell. Speculators who are "long" or "short" in the futures markets expect to profit from the difference between the subsequent price of the physical, (or cash) commodity and the price at which they purchased the futures contract.

Spreads

Many professional traders employ a trading strategy, frequently referred to interchangeably as spread or straddle trading which is usually considered more conservative than outright long or short positions. Spreads involve the simultaneous holding of a long position (contract to buy) in one futures contract and a short position (contract to sell) in a related futures contract. The two positions are called the "legs" of the spread. Spread traders hope to profit from changes in the difference between the prices of the two positions. They try to trade spreads when they think prices for the different months are "out of line." This trading strategy is similar to and sometimes referred to as arbitrage.

For example, there is normally a relatively stable relationship between the price of June gold and the price of September gold. This relationship is based on the costs of storing gold (including financing costs) from June to September. Should there be an influx of buy orders for June gold, there would be upward pressure on the price of June gold contracts. Spread traders could then sell June contracts and buy September contracts, which would tend to restore the normal relationship between the two contracts. Because of the large number of spread traders, many markets trade spreads as a single unit; that is, they allow traders to buy and sell the two legs of the spread simultaneously.

3. Mechanics of trading

An individual can trade futures contracts by opening a commodity account with a brokerage firm which holds a membership in one or more commodity exchanges through its officers or partners or with a firm which is registered with the Commodity Futures Trading Commission as futures commission merchant (FCM) placing orders through an exchange member. The firm arranges execution of the individual's orders to buy or sell and charges a commission for these transactions. In addition, the firm requires that the individual sign a margin agreement and maintain at least a minimum amount of cash in a margin account.

4. Comparison: futures v. corporate stock

In general

Although aspects of futures trading appear similar to practices and terminology used in securities trading, there are substantial differences between futures and securities trading. Some of these differences are very significant. Unlike corporate stock which a purchaser may hold indefinitely, futures contracts have a limited life span. Holders of futures either must liquidate them prior to their final delivery, date, or must make or accept delivery of the commodity pursuant to the contracts.

Payment

When corporate stock is purchased, the buyer must pay the seller the full amount of the purchase price. However, commodity traders do not make any payment for their futures contracts until the contracts' delivery dates. When they enter the contracts, traders merely

make a deposit, similar to earnest money, to guarantee performance in the future.

Margin

Margin requirements in futures trading differ greatly from margin requirements in securities trading. The margin established for securities purchases constitutes partial payment for the securities. The remainder of the securities' purchase price is loaned by the broker to the customer, who pays the broker interest for the borrowed portion of the purchase price. Minimum margin requirements may range well over 50 percent of the price of securities. Securities margin requirements are subject to Federal regulation.

In futures trading, however, a margin deposit is not a partial payment on the contracts. The margin deposit required for futures trading technically is "earnest money," a cash deposit made as a financial guarantee to the broker that the individual will fulfill his or her future obligations. Margin required for commodity futures accounts generally amounts to 5 to 10 percent of the face amount of a contract. Margin on individual accounts are set by the broker, who as an exchange member, must meet in turn margin requirements established by the exchange. Margin requirements for futures are not regulated by the Government. Thus, broker-set margins reflect exchange requirements.

Margins for futures are higher for positions involving greater risk and lower for positions with less risk. Hedgers have significantly lower margin requirements than speculators because hedgers hold the underlying physical commodity. Speculators' margin requirements depend on the risk of their net position. Spread or straddle positions, usually less risky than outright long or short positions, often have margin requirements of only one percent of the face amount of the two positions.

Exchanges require two types of margin deposits: initial and maintenance. Initial margin is the deposit amount required when the futures positions are established. Maintenance margin is the minimum amount of margin which must be maintained in the margin account at all times to support a position. Maintenance margin is usually set at 75 percent of initial margin. Margin requirements are recomputed daily based on the contract's settlement price, the official price set daily by the exchange. If a trader's overall position declines in value, the amount of the decline will be withdrawn from the margin deposit and paid over to the exchange clearing association. If the trader's margin drops below the maintenance level, the trader will have to deposit additional margin, called variation margin, before the next business day to bring the trader's margin back up to the initial level, or his undermargined positions will be liquidated.

Marking-to-market

If a trader's position has increased in value during the day, the net increase in the position is computed and transferred to the trader's account before the beginning of trading the next day. The trader has the right to withdraw the full amount of such gains immediately every trading day. However, if a trader's position decreases in value, the

trader will have to meet a margin call, that is, deposit additional funds before the next business day. Money paid on position losses is paid into the exchange clearing association which transfers such amounts to those accounts which gained during the trading day. This daily determination of contract settlement prices and margin adjustments to reflect gains and losses is called "marking-to-market."

Marking-to-market requires daily cash adjustments through the exchange clearing association to reconcile exchange members' net gains and losses on their positions. At the close of trading each day, every member must mark all customer accounts to the settlement prices (current market value) for the day. Gains and losses are immediately deposited into or withdrawn from the customer accounts. And, customers in turn are entitled to withdraw their gains, or are required to deposit any margin required because of losses in their accounts at the close of every day under this marking-to-market system.

Leverage

Because the margin deposits required for commodity accounts are so small, leverage—the relation between the amount of money required to control property and the value of the property—is significant. Moreover, unlike an investor who purchases stock on margin, a commodity futures trader does not buy or sell the commodity when he enters the contract. In acquiring a futures contract, a commodity trader only promises to buy or sell the commodity at a future time. If the trader is a speculator, the trader probably does not plan to hold the contract to maturity, but instead intends to liquidate it by executing an offsetting contract. Thus, the speculator would never be required to pay the full face amount of the contract (or to accept or deliver the commodity itself). When a trader liquidates his position, he receives back the amount in his margin account, as of the date of liquidation, less any commission. If the value of his contracts has increased since they were executed, the trader's margin account will have increased by the amount of the gain (unless the trader previously withdrew the gain). Losses on the contracts will be reflected by the total decrease in the original deposit in the margin account as well as any additional amounts paid in by the trader to meet margin calls. With a very small deposit, as low as five or even one percent of the value of the commodity covered by the contracts, a futures trader can speculate for the profits to be earned (or loss to be incurred) on the full 100 percent of the value of the commodity in the contracts.

Commissions

In securities transactions, brokers immediately charge customers a commission for any security purchased. Brokers also impose an additional commission for any subsequent sales. In futures transactions, however, commissions are charged only after the entire transaction is completed. Ordinarily, no commission is charged when a contract is purchased; the commission is assessed subsequently on a "round-trip" basis when the contract is liquidated.

Options

Certain tax-shelter transactions, including some straddles, can be executed with options. Options differ markedly from both stock or

securities and from futures contracts. An option is the right to buy or sell stock (or other property) at a stated price for a fixed period of time. A "call" is the right to buy stock (or other property) at a stated price, and a "put" is the right to sell stock (or other property) at a stated price.

There are two parties to an option transaction, the "writer" of the option, and the "holder" or "buyer" of the option. The writer of a call obligates himself, for a fee (often called the "premium"), to sell stock for a stated price (often called the "striking price") for a stated period of time. For example, he might write a call to sell 100 shares of IBM for $50 per share, for a period of 3 months. The holder of the call pays the premium and obtains the right to buy the IBM stock, at the $50 per share price, for three months. A "put" is just the reverse of the call. The writer of the put promises to buy the IBM stock at $50 per share for a period of three months, and the holder has the right to sell to him at that price if he wishes to do so.

The holder of a call believes the market price of the stocks may rise during the option period (in which case he will exercise his call and acquire the stock at a bargain price). The holder of a "put" feels the market price of a stock may decline, in which case his put will enable him to sell stock at more than its then current market value.

Basically, the obligations of an option writer may terminate in one of three ways: by exercise, lapse, or through a closing transaction. An exercise occurs where the holder of an option utilizes his right to make the writer of the option buy or sell stock at the agreed upon price. A lapse occurs where the holder does not exercise his option during the option period (usually because the holder has incorrectly predicted the trend of the market, so that the option is worthless) and the option period expires. A closing transaction occurs where the writer of the option terminates his obligation under that option by reacquiring it, or by making a payment to an options exchange equivalent to the value of an offsetting option. For example, if X writes a call obligating himself to sell 100 shares of IBM at $50 per share, and the market price of IBM moves upward to $60, X could neutralize his own position with respect to IBM stock by acquiring (through the medium of an options exchange) a call from Y allowing X to purchase 100 shares of IBM from Y for $50 per share. (Of course, X would have to pay a greater premium to Y for this call than X himself had received because of the upward movement in the price of the underlying IBM stock.)

Until 1973, put and call options in stock were traded exclusively "over-the-counter" through put and call brokers. The over-the-counter options are contracts between a specific buyer and specific writer. This means that while the buyer can exercise his option any time he wishes, the writer cannot relieve himself of his obligation except by repurchasing the specific option he has written. (The writer can, however, hedge by buying a similar option if he is willing to pay the relevant commissions and premiums.)

Trading on listed options now is conducted on several exchanges. Unlike over-the-counter options, listed options consist of two contracts—one between the buyer and the options exchange and the other

between the writer and the options exchange. A writer of a listed option can relieve himself of his obligation by buying a listed option identical to the one he has written. This is called a "closing transaction." The options exchange then cancels the two identical options.

In addition to options in stocks, exchanges plan to offer options in debt instruments. The Securities and Exchange Commission has authorized the Chicago Board Options Exchange to begin trade soon in options on Ginnie Mae certificates. Applications for additional debt options, including options on Treasury bills, are pending before the SEC.

Futures exchanges have applied to the Commodity Futures Trading Commission for permission to expand their listings to include options on futures contracts on debt instruments. Many of the applications pending before the CFTC pertain to options on futures on the same debt instruments for which applications to trade options have been filed with the SEC.

5. Execution of trades

Commodity futures transactions are traded in pits or rings on the floors of the exchanges by floor brokers and floor traders. These individuals, who must be members of the exchange, execute trades for themselves, for member firms and for others. Orders are phoned to managers near the pits who record the orders on slips which runners deliver to floor traders for execution. The trader executes the order by offering the contract by open outcry and hand signals. If another trader accepts the contract, the order is signed as executed by the floor trader and returned by a runner to the firm floor manager. The traders for each side of the contract confirm execution of the order to the clearinghouse. At the end of each trading day, member firms confirm all transactions reported during the day to the clearinghouse, which matches all the trades. The clearinghouse becomes the opposite party to each trade.

6. Price-setting

When long or short positions are traded separately in the pits, the price of each contract is set in the pits by competitive bidding at the time the two traders executing the trade mark agreement. However, when spreads (straddles) are traded as a unit, the floor traders competitively bid and offer the amount of the spread, which in a trading convention, is stated in terms of the contract delivery months, e.g., May–August, and the difference in prices, e.g., 10. The separate prices for each leg of the contract are set later by the two traders outside the pit. Under exchange rules, the price of one leg of a spread must be an *actual price* traded during the day in that contract month. The second leg must be a *possible price*, that is a price which falls between the day's price limits, i.e., the maximum movement up and down which a commodity price is allowed on a single day. Thus, if a contract, which begins a day at 80, and which has limits up and down of 10 in either direction, is actually traded between 75 and 81, the spread traders can assign an actual price between 75 and 81 to one leg, and a "possible" price as low as 70 or as high as 90 to the other leg, provided the spread differential of 10 is maintained.

D. Tax Shelters

The tax shelter potential of certain transactions in commodity futures has been recognized by the investment industry for decades. However, only in the last ten to fifteen years has the use of tax shelters in commodity futures extended beyond commodity and investment professionals to significant numbers of taxpayers, individual and corporate, throughout the economy. The tax advantages of spread transactions in futures are touted in commodity manuals, tax services, and financial journals. Brokerage firms have promoted tax spreads or straddles to their clients. Domestic and offshore syndicates advertise tax straddle shelters for which purchasers pay an amount equal to a percentage of their desired tax loss.

1. Tax straddles

Use of tax straddles

Simple commodity tax straddles generally are used to defer tax on short-term capital gains from one tax year to the next tax year and, in many cases, to convert short-term capital gain realized in the first year into preferentially taxed long-term capital gain in a later year. However, in some cases (described below) straddles are used to defer tax on ordinary income and convert that income into short- or long-term capital gain. A simple straddle is constructed by taking equal long and short positions in the same property in the same market. The two positions, called "legs," are expected to move in opposite directions but with approximately equal absolute changes. Thus, for example, if one leg of a straddle in futures contracts increases $500 in value, the other leg can be expected to decrease in value by about the same amount. By maintaining balanced positions, the risks of the transaction are minimized.

A taxpayer using a simple futures straddle as a tax shelter will establish a position in contracts with contract prices of about, say, $10,000 each. The two contracts one to buy, the other to sell, are identical in every respect, except for their delivery months. Because the taxpayer's position is a straddle, his margin deposit will be very low—as little as one percent of the value of the position ($200). The taxpayer will wait for the market move, so that one leg of the straddle shows a loss, e.g., $500, and the other leg shows an almost identical gain. The taxpayer will liquidate the loss leg by entering into the opposite futures contract for the same month. (A contract to sell December wheat, for example, is liquidated by executing a contract to buy December wheat.) In order to maintain a balanced, minimal-risk position, the taxpayer will replace the liquidated leg with a contract which is identical, except for its delivery month. The replacement contract will have a contract price of about $9,500.

The taxpayer will claim the decrease in value in the liquidated leg as a $500 short-term capital loss and deduct it from his income, thereby eliminating a $500 short-term gain for the tax year. At the same time,

the taxpayer will continue to hold the other leg, which will have an unrealized gain approximately equal to his "realized loss," that is, about $500. However, the taxpayer will not have paid out any money because no money is due on a futures contract until its delivery date. In addition, because the taxpayer maintained a balanced position, he ordinarily will not be required to put up any additional margin.

The taxpayer will hold the two legs into the following year. In the second year, the taxpayer will close out the two positions. Assuming the holdover contract has increased another $500 in value, the taxpayer will recognize a total gain of about $1,000 on the original leg and about a $500 loss on the replacement leg. If the gain is on the long (buy) position and that position was held for over six months, the taxpayer will report a $1,000 long-term capital gain and a $500 short-term capital loss. If he has no other capital transactions for the year, he will report the $500 difference between these legs as long-term capital gain. (His margin, less commissions, will be returned.) Thus, he will have succeeded in deferring his short-term capital gain for one year and converting it to a long-term capital gain. If the gain is in the short (sell) position, the gain will be short-term capital gain. In this case, the taxpayer gets a one-year deferral, but no conversion.

Certain commodity futures trading practices have facilitated tax straddle transactions. Exchange rules at the New York Commodity Exchange (COMEX), for example, provided for "after-hours" trading in spreads under extraordinary circumstances. During such trading sessions, only spreads were traded. In the late 1970s, however, COMEX after-hour sessions in silver futures occurred almost daily. Special sessions at the end of the calendar year lasted hours and drew press attention and comment. In 1980, after investigations suggested that abuses and violations of the Commodity Exchange Act rules, as well as significant tax-oriented trading, occurred during after-hours trading, the Commodity Futures Trading Commission suspended the sessions. In April 1981, the Commission announced that its intention to disapprove the COMEX rule providing for these sessions.

Revenue Ruling 77–185

In 1977, the Internal Revenue Service issued Revenue Ruling 77–185,[1] which disallowed deductions for losses and expenses in a simple two-contract silver straddle transaction. The ruling stated that the loss claimed by the taxpayer in connection with the disposition of one leg of the straddle was not *bona fide* because the disposition represented no real economic change and was not a closed and completed transaction. Moreover, the deductions for the loss and expenses were denied because, the ruling held, the transaction was not entered into for profit, but for tax-avoidance purposes.

Although the ruling discusses a two-contract (two-leg) silver straddle, many commodity experts have interpreted the ruling as applying to more complex "butterfly" straddles which involve four (or more) legs. Butterfly straddles, like simple straddles, are structured to create tax benefits regardless of the direction in which the market moves. (See item 6, "Butterfly straddles," below.) Butterfly straddles avoid risks entailed in single-spread straddles, that the gain will occur on

[1] Rev. Rul. 77–185, 1977–1 C.B. 48.

the short leg of the straddle, thereby preventing conversion of short-term gain into long-term gain. The ruling has aroused controversy. Two lead cases [2] involving IRS deficiency determinations under the theory in Revenue Ruling 77–185, are currently litigated in the United States Tax Court.

Despite resistance to the IRS position, the ruling has caused some investment advisers to counsel greater caution with respect to tax straddle activity. Some have encouraged clients to vary their trading pattern from the facts outlined in the ruling; others arrange multiple, difficult-to-audit futures trades for their clients in order to give greater evidence of a profit-making motive. Because the IRS ruling dealt with a silver straddle, some tax straddlers switched to other commodities, particularly gold and Treasury bills. Some investment counselors now discourage tax straddles altogether.

Silver was a popuar tax-shelter commodity because there generally has been a stable relationship between the price of silver contracts in different months. As noted above, this relationship is based on the costs of holding silver from one month to the other. Thus, the risks of spread trading were considered smaller than in other commodities. However, daily trading in silver was highly volatile, resulting in significant upward and downward price movement. This pattern was conducive to planning significant losses for tax purposes because the typical spread position provided a sizable gain on one leg and an almost precisely equal loss on the other leg. The silver market was considered a contango premium market, that is, a market in which distant futures sold at a premium over spot prices (the current price for the cash commodity) and nearby futures. Moreover, because the supply of silver was considered relatively stable, the price increases over time were largely a function of interest and storage for the silver until the commodity's delivery date, not sudden changes in supply.

The 1977 IRS ruling caused some tax straddlers to abandon silver. The extraordinary silver market crisis in March 1980, which some observers attributed to an attempt to corner the market, while others attributed to interference with market operations by short traders, led most remaining tax straddlers to abandon silver. Subsequently, tax straddle traders turned to other, more predictable commodities with premium market features similar to those which had previously characterized silver. Other precious metals and financial paper became the primary shelter commodities. However, tax straddles also can be executed in agricultural commodities, particularly those commodities which can be stored for long periods.

2. Straddles in Treasury bill futures

Tax straddles in Treasury bill futures offer an additional feature unavailable in other futures straddles. These shelters can be used to convert *ordinary* income, that is, salary, wages, interest, and dividends, into long-term capital gain. This opportunity occurs because, under statutory rule, gain or loss on the sale of Treasury bills is considered ordinary income or loss, while, under IRS interpretation, gain or loss on the sale of T-bill futures contracts is considered capital gain or loss. Straddles in Treasury bill futures generally are structured in the same way as other futures straddles: contracts to buy Treasury

[2] *Smith* v. *Commissioner*, Docket No. 12709–77, and *Jacobsen* v. *Commissioner*, Docket No. 185–78.

bills are offset by an equivalent number of contracts to sell Treasury bills. The execution of these "T-bill" shelters involves one difference: when the delivery month for the loss leg of the straddle arrives, the taxpayer takes delivery of the bills and then disposes of the bills themselves creating an ordinary loss, fully deductible against any typ of ordinary income.

The remainder of the straddle transaction is executed in the usual fashion. The taxpayer immediately replaces the liquidated leg. In the following year, the entire straddle is closed out and, if the gain occurs on the long position (contract to buy), the gain is reported as long-term capital gain.

Of course, some taxpayers shy away from paying even preferential capital gains rates. These taxpayers may decide to re-straddle in the second year and roll-over their gains and other income indefinitely into the future.

3. Straddles in corporate tax planning

Tax straddles can be used for tax planning by corporations. Transactions can be structured so that income can be deferred to later years, or corporate losses or tax credits utilized by disposing of a straddle's gain leg in the initial year. Tax journals have publicized a number of planning techniques involving the use of straddle shelters.

Corporations with international operations are advised to take advantage of currency futures straddles. Legitimate hedging positions can be transformed into tax shelters by treating some offsetting contracts as straddles. Loss contracts can be liquidated and replaced so that losses offset income in one year. All the while, the company's hedging operations in currency futures remain in place, protecting the company's position in world currency markets.

Businesses with debt holdings or offerings also can easily execute transactions in futures contracts in debt instruments, such as Treasury bills or Ginnie Mae certificates, to create tax benefits. "Losses" can be created to defer income. However, gain positions might be realized in order to use up expiring capital loss carryforwards in one year and to "renew" the loss in the next year. Similarly, corporations can set up these "reverse" straddles to take advantage of expiring foreign tax credits.

While these shelter transactions in futures are subject to challenge under Revenue Ruling 77–185, their detection might be difficult. If a corporation has legitimate business purposes for engaging in futures transactions, it might be hard for auditors to distinguish tax-motivated transactions from regular business dealings in futures. Even if tax-shelter transactions are identifiable, it might be difficult for the Internal Revenue Service to prove that the transactions were tax-motivated and had no business purpose.

4. "Cash and carry" transactions

"Cash and carry" tax shelters involve the purchase of a physical commodity, for example, silver, and the acquisition of a futures contract to deliver (sell) an equivalent amount of the same commodity twelve months in the future. The taxpayer finances the purchase with borrowed funds, and deducts the interest expense, storage and insurance costs in the first year. These deductions offset ordinary investment income, e.g., interest and dividends.

Because the price differential between the current price of the physical commodity and the futures price is usually largely a function of interest and other carrying charges, the futures contract will have a value approximately equal to the total payment for the physical commodity plus interest and carrying costs. The taxpayer will hold the silver and the offsetting futures contract into the next year.

When the 12-month holding period has passed, the taxpayer will deliver the silver on the futures contract and realize a gain on the silver. If the price of silver has increased, the taxpayer can sell the silver, producing long-term capital gain, while closing out the short futures position, creating a short-term capital loss. In either event, the gain will be about equal to the interest and carrying charges but will be treated as long-term capital gain. Thus, investment income taxable at rates as high as 70 percent, would be deferred for a year and converted into capital gains taxable at maximum rates no higher than 28 percent.

5. Broker-dealer shelters

Securities dealers have special tax-shelter opportunities which straddles makes even more profitable. A securities dealer who identifies some assets as held for investment within 30 days of their acquisition as required under Code section 1236, receives capital gains (or loss) treatment on such assets. Other assets held for sale or as inventory produce ordinary income or loss. If a securities dealer selects and marks certain assets as investments, and treats other, balancing items as inventory, advantageous tax straddles can be structured which are claimed on the broker-dealer's tax return as producing capital gains or losses in his "investment" account and ordinary income and loss from his inventory. Dealers in debt instruments can straddle ordinary income Treasury bills against debt which produces capital gain or loss. Treasury bill futures transactions add even more planning opportunities.

Some taxpayers consider securities dealers' unique tax-planning opportunities so significant that they establish themselves as broker-dealers solely to exploit these opportunities. Large broker-dealer partnerships pass these tax benefits through to hundreds of "partners." Many of these broker-dealer partnerships sell shares in their operations for fees which are based on a percentage, usually ten percent, of the tax loss sought by the investor. Some operations are established off-shore in order to avoid domestic regulatory officials and to prevent the Internal Revenue Service from obtaining their records for audit purposes.

6. Butterfly straddles

A butterfly straddle [3] is a commodity futures spread entailing at least four positions. A butterfly straddle generally is composed of two simple, mirror-image spreads with the same intermediate delivery date.

The butterfly straddle can consist of a long position in a futures contract with a near delivery date, a long position in a futures contract with a distant delivery date, and two short positions in a futures

[3] The name "butterfly" apparently was given to this operation because, if diagramed a certain way, the transaction resembles a butterfly.

contract with an interim delivery date. A butterfly straddle also may be structured with one near and one distant short position and two interim long positions.

Because the two spreads in the butterfly are established as mirror images of each other, the butterfly provides protection against a change in the price of the commodity whether the market moves up or down and also against any change in the price of the spread. It also makes it very likely that at least one long position will produce a gain, which can be used to convert short-term gain into long-term gain.

EXAMPLE: GOLD BUTTERFLY STRADDLE

The following example outlines the steps in executing a butterfly in gold futures contracts (100 troy oz.). The following prices are rounded from closing prices listed for contracts traded on the New York Commodity Exchange (COMEX) the middle of April 1981.

Gold Futures—100 Troy oz.

Contract:	*Cost per oz.*
February 1982	$550.00
April 1982	560.00
June 1982	570.00
August 1982	585.00
October 1982	600.00
December 1982	610.00
February 1983	625.00

STEP I: APRIL 1981

Establish straddle:

Buy Feb. 1982—Sell June 1982, Sell June 1982—Buy Oct. 1982

Taxpayer deposits one percent of contracts' face value ($229,000) as *margin: $2,290.*

STEP II: SEPTEMBER 1981

Assume price of gold declined 10 percent:

	September 1981
February 1982	$495
June 1982	513
October 1982	540

The straddle has potential losses in its February and October long positions and approximately equal gains in its two June short positions:

February 1982	−5,500
October 1982	−6,000
June 1982	+5,700
June 1982	+5,700
Economic gain	−100

Because taxpayer wants tax losses, he closes out loss legs (Feb. and Oct.) with two new straddles:

Sell February—Buy April, Buy August—Sell October

As a result of executing these two straddles, the taxpayer's position now is:

Buy April—Sell June, Sell June—Buy August

The taxpayer thus has the two June contracts still in place with profits of $11,400, all the while maintaining the spread positions. The profit of $11,400 belongs to the taxpayer as a matter of right. The taxpayer may have already withdrawn the profits as they were credited daily to his account. The taxpayer has a tax loss of $11,500 for 1981. Generally this will be a capital loss deductible against capital gains and up to $3,000 of ordinary income.

Step III. March 1982

Assume additional 10-percent decline:	*March 1982*
April 1982	$453.6
June 1982	461.7
June 1982	461.7
August 1982	473.8

Taxpayer closes out all positions by executing offsetting spreads which cancel his positions:

Sell April———Buy June, Buy June———Sell August

The two June positions have gained $10,830 each:	
June	+10,830
June	+10,830
The April position lost $5,040 since it was entered at $504 per oz. in September 1981:	
April	−5,040
The August position lost $5,270 since entered in September 1981 at $526.5 per oz.:	
August	−5,270

Taxpayer recognizes gain of $11,350 for 1982. (Of course, gain credited to the taxpayer's account in 1981 may have been withdrawn by him in that year.)

Summary

If gain is recognized on a long position held over 6 months, as in this example, it is taxed as long-term capital gain even though the losses in the prior year were deducted against short-term capital gains.

Taxpayer's actual economic change on the butterfly is determined by reducing total gains by total losses:	
All gains	+21,660
All losses	−5,040
	−5,270
	−11,500
Net economic loss	−150

Alleged tax savings for 1981: $8,050 (assuming 70-percent bracket).

The taxpayer can enter into a new straddle to generate losses to deduct against the $11,350 of gain for 1982. Alternatively, he can pay tax of $2,951 on the long-term gain (assuming a 70-percent tax bracket). In this case, the tax benefit is $5,099 ($8,050−$2,951) plus the advantage of a one-year deferral.

III. EXPLANATION OF H.R. 1293*

A. Tax Treatment of Straddles

Present law

Under present law, gain or loss from the sale or other disposition of property is generally recognized by a taxpayer at the time of the disposition of the property (unless non-recognition is specifically provided for by a provision of the Internal Revenue Code).[1]

Wash sales

The Internal Revenue Code includes a wash-sale rule providing for non-recognition of certain losses which do not constitute true economic losses. This provision disallows any loss from the disposition of stock or securities where substantially identical stock or securities (or an option or contract to acquire such stock or securities) is acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date.[2] This provision prevents a taxpayer from selling stock which has declined in value in order to establish a loss for tax purposes, and immediately reacquiring similar stock, because the sale and reacquisition together do not significantly alter the taxpayer's position with respect to that stock. No similar Code provision applies with respect to the disposition of property other than shares of stock or securities.[3]

Capital gains and losses

Generally, under present law, gain or loss from the sale or exchange of a capital asset [4] receives special treatment. In the case of individuals, only 40 percent of the excess of the net long-term capital gain over net short-term capital loss for any taxable year is included in the taxpayer's adjusted gross income.[5] In addition, capital losses of in-

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*Introduced by Messrs. Broadhead, Rosenthal, Downey, Ford (Tenn.), Pease, Rangel, Shannon, and Stark. H.R. 1338, an identical bill, was introduced by Messrs. Rosenthal and Brodhead, and Edwards (Calif.), St Germain, Rodino, Harkin, Peyser, Conyers, Won Pat, Pepper, Forsythe and Hughes, and Ms. Mikulski.

[1] Code sec. 1001. However, losses are allowable only if incurred in a trade or business, incurred in a transaction entered into for profit, or resulting from casualty or theft.

[2] Code sec. 1091.

[3] For this purpose, commodity futures are not treated as stock or securities. Rev. Rul. 71–568, 1971–2 C.B. 312.

[4] Code sec. 1221. Capital assets generally include all property held by the taxpayer other than inventory, depreciable property or real property used in a trade or business, certain taxpayer-created property, certain receivables and certain short-term government obligations.

For this purpose, commodity futures contracts may not qualify as inventory. However, they are not allowed capital gains treatment if used as an integral part of the taxpayer's business, such as farming or food processing. *Corn Products Refining Co.* v. *Com'r.*, 350 U.S. 46 (1955).

[5] Code sec. 1202.

dividuals are deductible in full against capital gains, and against up to $3,000 of ordinary income each year.[6] Only 50 percent of the net long-term capital losses in excess of net short-term capital gain may be deducted from ordinary income.[7] Capital losses in excess of this limitation may be carried over to future years indefinitely, but may not be carried back to prior years.[8]

In the case of a corporation, the net capital gain is taxed at an alternative rate of 28 percent.[9] Capital losses are allowed only against capital gains.[10] Any excess loss may be carried back three years and forward five years.[11]

Generally, in order for gains or losses on the sale or exchange of capital assets to be considered long-term capital gain or losses, the assets must be held for one year or more.[12] In the case of futures transactions in any commodity subject to the rule of a board of trade or commodity exchange, the required holding period is six months.[13]

Short sales

In the case of a "short sale" (i.e. where the taxpayer sells borrowed property and later closes the sale by repaying the lender with identical property), any gain or loss on the closing transaction is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer,[14] but the gain ordinarily is treated as short-term gain.[15] A contract to sell is treated as the short sale for purposes of these rules.[16]

The Code contains several rules which were enacted to eliminate specific devices in which short sales could be used to transform short-term gains into long-term gains. Under these rules, if a taxpayer holds property for less than the long-term holding period and sells short substantially identical property, any gain upon the closing of the short sale shall be considered short-term gain, and the holding period of the substantially identical property will generally be considered to begin on the date of the closing of the short sale.[17] These rules prevent the conversion of short-term capital gain into long-term capital gain

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[6] Code sec. 1211(b)
[7] Code sec. 1211(b)(1)(C)
[8] Code sec. 1212(b)
[9] Code sec. 1201
[10] Code sec. 1211(a)
[11] Code sec. 1212(a).
[12] Generally, options held for investment are governed by the same provisions of the Internal Revenue Code as are other capital assets. However, section 1233(c) exempts certain options to sell property from the short sales rules if the options were acquired on the same day as the property and the option, if exercised, is exercised through the sale of the property. Section 1234 provides that gain or loss from the sale or exchange of an option has the same character as gain or loss from the sale or exchange of the property underlying the option, if the property were in the hands of the taxpayer. Gain or loss from closing transactions in options is treated as short-term capital gain or loss.
[13] Code sec. 1222.
[14] Code sec. 1233(a).
[15] Code sec. 1233(b)(1). However, if on the date of a short sale, the taxpayer has held substantially identical property for over a year, a loss on the closing of the short sale will be treated as a long-term capital loss. Sec. 1233(d).
[16] Thus, in any commodity contract transaction, the person with the obligation to sell may not qualify for long-term capital gains.
[17] Code sec. 1233(b)

where the taxpayer is free of any significant risk. Also, if a taxpayer has held property for more than one year, and sells substantially identical property short, any loss on the closing of the short sale shall be considered long-term capital loss.[18] This rule prevents the conversion of long-term capital loss into short-term capital loss. For purposes of these rules, property includes stock, securities, and commodity futures,[19] but commodity futures are not considered substantially identical if they call for delivery in different calendar months.[20] In addition, these rules do not apply in the case of hedging transactions in commodity futures.[21]

Straddles

Generally, the Internal Revenue Code does not contain any special rules dealing with straddles in commodities or futures contracts in commodities.[22] In the case of the typical straddle in commodities (i.e. the holding of a contract to buy a commodity in one month and the holding of a contract to sell the same commodity in a different month), neither the wash sale rule applicable to stocks or securities (sec. 1091), nor the special short sale rules preventing conversion of short-term gain to long-term gain, or long-term losses to short-term losses (secs. 1233(b) and (d)) apply.

However, the Internal Revenue Service has ruled[23] that the loss from certain silver futures contracts was not deductible because the taxpayer "had no reasonable expectation of deriving an economic profit from the transactions."[24] This ruling has been the subject of much controversy, and the IRS is litigating the deductibility of certain straddle transactions in the courts.

Explanation of provision

The bill would provide that if a taxpayer holds a straddle (i.e., offsetting positions), the portion of any loss with respect to any of the positions in the straddle which exceeds recognized gain from any such positions may not be recognized for the period during which the taxpayer holds the offsetting positions plus the 30 days after the day on which the positions cease to be offsetting (called the "balanced period"). The 30-day period is similar to the period contained in the wash sale provision.

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[18] Code sec. 1233(d)

[19] Code sec. 1233(e)(2)(A)

[20] Code sec. 1233(e)(2)(B)

[21] Code sec. 1233(g)

[22] Section 465 of the Code does contain rules limiting losses from an activity to amounts which certain taxpayers have "at-risk" in that activity. These rules are generally applicable to all activities, other than real estate, in taxable year beginning after 1978. It is unclear if these rules might apply to straddles.

[23] Revenue Ruling 77–185, 1977–1 C.B. 48.

[24] In the transaction described in the Revenue Ruling, the taxpayers on August 1, 1975, simultaneously sold silver futures contracts for July delivery and purchased an identical number of silver futures contracts for March delivery. Three days later, the March contracts were sold for a loss and an identical number of May contracts were purchased. On February 18 of the following year, the taxpayer simultaneously sold the May contracts and purchased July contracts to cover the short position. The taxpayer reported a loss from the sale of the March silver contracts in 1975 which reduced its short term gain from the sale of real estate and reported a net long-term gain in the next year from the sale of the futures contracts.

However, if the taxpayer disposes of all of the offsetting positions before the close of the 30-day period, the balanced period would be treated as ending on the day of the last such disposition by the taxpayer. Thus, taxpayers who close out their offsetting positions would be allowed to recognize, at that time, any otherwise allowable loss sustained on such positions. This rule is intended to benefit hedgers, such as farmers or cereal processors, who establish offsetting positions in commodity future contracts in order to protect their selling price or costs until the actual sale of their crops or the purchase of their inventory requirements.

In addition, the running of holding periods for each of the straddle positions would be suspended for the balanced period, generally the period during which the positions are offsetting plus 30 days. However, in determining the taxpayer's holding period for any position, any period during which the position was held prior to the establishment of an offsetting position could be tacked to any period during which that position was held after the close of the balanced period.

The bill defines the term "straddle" as offsetting positions with respect to personal property including, for example, commodities, debt obligations, currency, or stock. Under the bill, a taxpayer would hold offsetting positions if there is a substantial reduction of the taxpayer's risk of loss from holding any position with respect to personal property because the taxpayer also holds one or more other positions with respect to personal property (whether or not of the same kind).

The bill would create a rebuttable presumption that if two or more positions are customarily treated as straddles or offsetting positions (whether or not called a straddle, butterfly, or similar name), or if the aggregate margin requirement for such positions is lower than the sum of the margin requirements for each such position (if held separately), the positions would be presumed to be offsetting unless the taxpayer establishes that they are not offsetting. The Secretary could prescribe by regulations other factors which indicate that two or more positions are offsetting and which would establish a rebuttable presumption that the positions are offsetting.

The bill would apply to positions in personal property which are interests, including futures contracts or options, in commodities, evidences of indebtedness, currency, and other types of personal property. If a taxpayer, within the period beginning 30 days before and ending 30 days after the date of the disposition which is part of an offsetting position, acquires a successor position, such successor position shall be treated as the same position as the position to which it succeeds. In addition, a successor position shall be treated as held on each day which intervenes between the disposition of the interest which it succeeds and the day on which such successor position is acquired. Personal property acquired by a taxpayer pursuant to a futures contract, option, or other interest will be treated as a successor position to such interest.

The bill would provide that positions held by related persons are treated as held by the taxpayer for purposes of determining whether any positions are offsetting. Under the bill, a person is a related person to the taxpayer if the relationship between such person and the taxpayer would result in a disallowance of losses under section

267 or 707(b), or if such person and the taxpayer are under common control (within the meaning of subsection (b) or (c) of section 414). However, an individual's family would consist only of the individual, his or her spouse, and the individual's children under 18 years of age. In addition, the bill provides attribution of positions to and from a partnership, trust, or other entity if any gain or loss with respect to a position held by such entity would properly be taken into account by a taxpayer with respect to whom the entity is not a related person.

Effective date

This provision would be effective for property acquired after January 27, 1981.

B. Capitalization of Certain Interest and Carrying Charges

Present law

Under present law, carrying charges, such as storage and insurance, and interest on indebtedness incurred or continued to purchase or carry a commodity held for investment is deductible as an expense paid or incurred for the management, conservation or maintenance of property held for the production of income (Code sec. 212), notwithstanding that the sale of commodity may result in long-term capital gain.

However, a limitation is imposed under Code sec. 163(d) on interest on investment indebtedness. Generally, the deduction for such interest is limited to $10,000 per year plus the taxpayers' net investment income. Any remaining amount can be carried over to future years.

Explanation of provision

The bill would require taxpayers to capitalize interest and carrying charges properly allocable to personal property which is part of a straddle (as defined in the bill and discussed above in section A). No deduction would be allowed for such charges, which would include interest on indebtedness incurred or continued to purchase or carry the property, and amounts paid or incurred for insurance, storage costs, and transportation costs.

Effective date

This provision would be effective with respect to property acquired after January 27, 1981.

C. Treatment of Short-Term Government Obligations as Capital Assets

Present law

Under present law, most assets held for investment are treated as capital assets. Net long-term gain from the sale or exchange of these assets results in favorable tax treatment and any deductions for net losses from sales or exchanges of capital losses are limited. (See discussion of capital gains under the present law discussion of straddles.) Gain or loss from the disposition of assets which are neither capital assets nor business assets is treated as ordinary and is not eligible for lower tax rates nor subject to the capital loss limitations.

Certain governmental obligations (Treasury bills) issued on a discount basis payable without interest at a fixed maturity not exceeding one year from the date of issue are not treated as capital assets (Code sec. 1221(5)). This provision was originally added to the Internal Revenue Code in 1941, to relieve taxpayers of the requirement of separating the interest element from the short-term capital gain or loss element when an obligation is sold before maturity.[1] Thus, all gains or losses from transactions in such obligations are treated as ordinary income or ordinary loss.

The IRS has held that a futures contract to purchase Treasury bills is a capital asset if held for investment.[2] Thus, for example, a taxpayer holding offsetting positions in Treasury bill futures may take delivery of the Treasury bills on the loss leg of the straddle and sell the bills themselves in order to convert the short-term capital loss on the futures contract into a fully-deductible ordinary loss on the bills.

Explanation of provision

The bill provides that obligations of the United States, of its possessions, of a State or political subdivision of a State, or of the District of Columbia, issued on a discount basis and payable without interest in less than one year, would be treated as capital assets in determining gain or loss. Thus, these obligations would be treated by the holder in the same manner as similar debt obligations. Any discount at issue would be treated as interest under generally applicable tax rules.[3]

Effective date

This provision would apply with respect to property acquired after January 27, 1981.

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[1] S. Rept. 673 (77th Cong.), Part I, p. 30.
[2] Rev. Rul. 78–414, 1978–2 C.B. 213.
[3] See e.g., *U.S.* v. *Midland Ross Corporation*, 381 U.S. 54 (1965).

D. Identification of Dealer Transactions in Securities

Present law

Under present law, gains and losses from property held primarily for sale to customers in the ordinary course of business are taxed as ordinary gains or losses. Gains and losses from property held for investment are taxed as capital gains and losses.

Gains and losses of a person from the sale of property of a type held by the person primarily for sale are generally ordinary. However, the Code contains a rule (sec. 1236) to allow a securities dealer to identify and segregate certain of its assets as held for investment. Gains and losses from the sale of these assets may be treated as capital gain or loss.

Under the rules, in order to receive capital gain treatment, the security must be "clearly identified" on the dealer's records as held for investment within 30 days following the date of acquisition and may not thereafter be held primarily for sale to customers. If a security is at any time clearly identified as held for investment, ordinary loss treatment is denied.

The term "security" means any share of corporate stock, any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to any of the above.

Because a dealer can wait 30 days to identify securities held for investment, the dealer may wait the 30 days to determine which securities rise in value. The dealer might choose to identify these appreciated securities as held for investment in the expectation that this appreciation will hold or continue and be eligible for preferential treatment as long-term capital gains. Also, the dealer might want to treat any securities which have declined in value as held primarily for sale to customers in order to treat losses from these securities as fully deductible ordinary losses.

Explanation of provision

The bill would require a dealer in securities to identify a security as held for investment not later than the day after the date of the security's acquisition instead of before the expiration of the 30th day after its acquisition, as required under present law.

Effective date

This provision would apply to property acquired by the taxpayer after the date of enactment in taxable years ending after that date.

E. Revenue Effect

The bill is expected to increase budget receipts by $1.3 billion in fiscal year 1982. Estimates for future fiscal years will depend upon judicial decisions.

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